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Step-In Right as a Lender Protection Mechanism in Project Financed Transactions

Murat Madykov*

This Article looks at the interesting and complex structure of step-in right in the context of project finance deals.

By default, lenders include step-in provision in project finance contracts to have a right to intervene in the project if it comes into difficulty. Indeed, when the sole guarantee for lenders is the security over the project's assets (in effect, financed by the lenders) the opportunity to interfere with contract relations of the project appears to be a powerful tool to revitalize the project. However, step-in right can be associated with serious legal and practical challenges and constraints, which can substantially limit or even nullify the effect of this protection strategy. This, of course, invites the question of the overall effectiveness of step-in right.

This Article discusses the meaning of step-in right and analyzes why lenders may want to include it in financing contracts. The Article provides that the economic value of the project is not its physical assets serving as a security but contractual arrangements allowing the project run; therefore, the right to step-in can be viewed as a perfect way to take control of the project and remedy the default situation. This Article also reviews different variations of step-in right and related contractual arrangements, events triggering step-in right and step-out considerations. The Article further shows how various jurisdictions may regulate lenders' rights and liabilities and thus affect the step-in activities. Finally, this Article seeks to answer the key question about the step-in mechanism: is the step-in right a plausible remedy for a lender in project financed transactions?

Upon discussion of various challenges and constraints associated with the step-in right, the Article argues that there cannot be a single concrete answer to the question of step-in right plausibility, however the Article

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proposes various measures that might be helpful for a potential lender to increase the efficiency of step-in right.

I. Introduction

Large-scale infrastructure, mining, energy and other industrial and development projects provide essential pillars for global economic growth. Many of these projects, in both developed and developing countries, have been financed through the medium of project finance. Project finance is “the raising of funds on a limited-recourse or non-recourse basis” to finance separate capital investment projects where “providers of the funds look primarily to the cash flow from the pro-
ject as the source of funds to service their loans and provide the return of and a return on their equity invested in the project."  

"Project financing has proved a very powerful tool for financing around the globe" over the last decades. "Although gathering reliable data is rather difficult, it is estimated that the value of investment brought about by project financing amounts to around EUR 200 billion globally every year." Such investment projects "can be found across the world in a range of sectors such as transport (e.g., roads, railways, airports, ports, light rail), energy (generation and distribution), environment (e.g., water and wastewater treatment and distribution, waste treatment), and social infrastructure (e.g., hospitals, schools, government buildings)." To ensure financing for the project, investors usually involve a bank or "a syndicate of banks as a lender who will provide loans to the project." The lender is the person who bears the risk of the project company's failure to fulfill the project. In this respect, when preparing a project financed transaction, the lender always needs a proper structure for its protection strategy.

"Step-in right" is one of the standard protection arrangements in project financed transactions. In general terms, "step-in" means a right of the lender to step into the shoes of the project company as a service provider. However, there is no standard definition of "step-in."

In its most traditional sense, it means that the [lender] (or its nominee) steps in to manage the project company's own resources used to provide the services. Or, more practically, it can mean that the [lender] either [temporarily] steers the services away from the [project company] or merely interposes a much greater level of hands-on management and control over the project company's service delivery."

1. JOHN D. FINNERTY, PROJECT FINANCING: ASSET-BASED FINANCIAL ENGINEERING 1 (2d ed. 2007).
3. Id.
4. Id.
7. Id. at 1-2.
As a regular box-checking exercise, lenders are advised to include a step-in right within the financing agreement. However, both advisors and financing institutions often underestimate the legal and practical challenges associated with such inclusion. Upon a closer look, these challenges could be substantial, as they may lead to unenforceability of the step-in right provision and ultimate failure of the project. Taking this into account, the goal of this Article is to determine whether the step-in right is a plausible remedy for a lender in project financed transactions.

In pursuing this goal, the Article will assess the theoretical and practical understanding of the step-in right concept. The Article will review, first, what constitutes the step-in right mechanism, the rationale behind it and key practical variations of step-in right. Viewing the step-in right as a complex contract law structure, the Article will also explore the regulation of lenders' rights and liabilities with respect to third parties in some jurisdictions. Furthermore, to answer the question of the plausibility of the step-in right, the Article will identify and try to weigh the potential benefits of the step-in right against the challenges and constraints related to its exercise. Namely, it will explore various risks related to triggering the step-in right, technical features of the project and lender's capacity, relationships with management and employees of the project company, government authorizations, and open competition requirements.

It must be recognized that due to lack of wide experience in the exercise of the step-in right, some of the problems discussed in this Article may seem theoretical. However, these are the problems which the lender should be prepared for when drafting the step-in right clause and, moreover, when the project comes into difficulty.

This Article will use several types of analyses. It will primarily employ a traditional theoretical analysis of the existing approaches to the subject at issue. The Article will also use a comparative law analysis


9. E.g., Interview with Philip Wood QC (hon), Special Global Counsel for Allen & Overy LLP, Head of Allen & Overy Global Law Intelligence Unit, Visiting Professor in Int'l Fin. Law at the Univ. of Oxford, Yorke Distinguished Visiting Fellow at the Univ. of Cambridge, Visiting Professor at Queen Mary College, Univ. of London (Mar 11, 2014) (a lawyer with 40 years of experience in international banking and finance, has noted that he has “never heard of the step-in right being exercised”) (on file with author); Telephone Interview with John T. Wallace, Lecturer at Law, Boston University School of Law, Managing Dir., Sr. Counsel & Practice Grp. Leader, Fixed Income, N. Am. Inv. L. for John Hancock Fin. Servs., Inc. (Mar. 13, 2014) (making same comment) (on file with author).
by contrasting the views of the step-in right in the U.S., the U.K. and French contract law traditions.

II. WHAT IS STEP-IN RIGHT?

A. Step-In Right as Part of Security System

Transferring control over the project to a lender under a contract constitutes the step-in right mechanism. The parties to this mechanism appear to correspond to the key parties to the common project financed transaction:

- Lenders: financial or bank institutions that provide funds for the project to the [project company or] Single Purpose Vehicle ("SPV").
- Sponsors [or grantors]: . . . the shareholders or companies that [organized the project company]. They provide some funding and guarantees for the project.
- [Project Company]: an entity . . . created with the single purpose of [implementing] a project.
- Contractors: parties in charge of developing and overlooking the construction of the project [(e.g., companies responsible for construction of pipeline)].
- Sub-contractors: parties providing ancillary or specialty services related to the project [(e.g., companies supplying and installing pipes, installing and testing measurement and control equipment, etc.)].

Although project finance may be defined through the terms of cooperation among the above parties, it should ultimately be considered as an aggregation of legal contracts that allocate resources and risks. Indeed, a "typical project has 40 or more contracts uniting 15 parties in a vertical chain from input supplier to output purchaser."11

The center of project finance is a loan (credit) agreement that controls the entire financing deal;12 the step-in right is a part of the protection system securing the interests of the lender provided in or arising out of the loan agreement. As a rule, inclusion of an agreed security package is usually a condition precedent to disbursement of

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12. GATTI, supra note 2, at 277.
the loan. Authors writing on project finance are more or less in agreement as to what normally constitutes the security package:

(a) pledge on project company shares;
(b) security on the project company’s receivables;
(c) security on the project company’s bank accounts;
(d) mortgage on the project’s real property (i.e., construction site, plant to be built, etc.);
(e) security on other project company assets, (provided that they have economic value and are permitted to be used as security in the respective jurisdiction); and
(f) direct agreements.

For the purpose of this research, a direct agreement poses the most interest. A direct agreement is a contract “executed directly by the lenders and the key counterparties to the project [contract],” such as sponsors, project company, contractors and sub-contractors. “The objective of a direct agreement is to grant the lender certain legal rights that apply when the relevant project contract is threatened with termination[.]” Direct agreements are also sometimes sought from the authorities issuing consents necessary for the project” and those parties providing necessary items (e.g., sponsor providing land necessary for a pipeline project). The following standard provisions of the direct agreement are the most important:

- The lender[ ] is given a ‘cure period’ (i.e., extra time to take action to remedy the Project Company’s default in addition to that given to the Project Company) before the [project company’s] contract is terminated. These cure periods are limited in length, . . . [sufficient for] the lender[ ] to take[ ] active steps to find a solution to the problem.

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13. See id. at 276.
15. Id. at 301-304.
16. Id. In this Article, “project contract” means various types of contracts in a project finance transaction, such as concession contract, EPC, services contract, loan agreement, supply contract, etc.
17. In public-private partnership/private finance initiative (PPP/PFI) arrangements, the direct agreement is a three-way (tripartite) agreement among the public authority, project company and the lender. Tim C. Meaney, DZ Bank, PPP Project Financing: The Role of Direct Agreements in a PPP Project 3 (Sept. 20, 2005), available at http://www.eu.gov.hk/english/cmps/cmps_20050930.html.
18. Id. at 3.
20. For example, this situation may relate to performance of an insurance contract when the project company is default in payment of an insurance premium to the insurance company. In this case the lender can pay the outstanding insurance premium instead of the project company and thus cure the default.
• The lender[s] has the right to ‘Step-In’ to the contract during the cure period. This means that it can appoint a nominee to undertake the Project Company’s rights in parallel with the Project Company [or substitute the project company].

• The lender[s] will normally not assume any additional liability as a result of Step-In or substitution [unless the lender exercises the step-in right itself].

• The Project Company undertakes not to obstruct the lender’s exercise of its Step-In and substitution rights.21

A direct agreement serves both defensive and offensive functions; defensive “in that it protects the [lender] against a precipitous termination of the project contract by the other contracting party [and offensive] in that it allows the [lender] to seize control of the project company’s rights under the project contract upon the general enforcement of its security.”22 It can be used by the lender as a “convenient instrument in which to place undertakings between the relevant contractual counterparty and the banks.”23 For example, a direct agreement can extend a license to use the counterparty’s intellectual property rights from the project company to the lender.24

A direct agreement is “usually negotiated at the same time as the project contracts[ ] and the form of the direct agreement is set out as an annex to the project contract.”25 It is also “known as a ‘consent to assignment’ if this is the main purpose of the agreement.”26

A direct agreement is an essential component of a project financed transaction and the risks which may arise out of it should be given a due consideration and careful assessment. Among the main risks mentioned by practitioners when discussing direct agreements, the key one is the complexity that “can arise when the contractor is also the [principal] shareholder of the [project company].”27 In the case of hostile relationship with the contractor “following a default by the [project company], . . . the lender[ ] may be forced to allow the [project] contract to be terminated.”28 This can happen because it is “[p]ractically very difficult to replace the contractor,” as the project finance contract usually contains a “completion date default provision which may [provide] the lender with limited time to cure the underly-

22. See Vinter et al., supra note 19, at 274.
23. Id. at 277.
24. Id.
25. See Yescombe, supra note 21, at 194.
26. Id. at 194 n.22.
27. Meaney, supra note 17, at 12.
28. Id.
The following will discuss other significant risks related to exercising step-in rights.

B. Why Step-In Right?

Prior to exploring the various practical variations of the step-in right, it would be advisable to understand why such structure exists and why it might be important from the lender’s perspective. It is clear that in project finance, project revenues are typically “the only source of loan reimbursement.” Therefore, “lenders actually find themselves in a rather weak position” de facto if the project company faces financial difficulties despite availability of the huge “system of contract solutions and security interests that lenders can rely on” in project finance deals. For instance, unlike in corporate financing, in project finance, the payment acceleration solution is quite illusory. Most of the available liquidity generated by the project company, excluding the liquidity essential to the survival of the project, is channeled to repay lenders. Acceleration of the loans “does not generate the financial resources needed to repay the loan, and by definition the project company does not have any reserve funds that it would have available to pay immediately to lenders in case of acceleration.”

Equally illusory is the option of enforcing security interests. “To benefit from security means to have a priority right to sell the secured item and retain the proceeds of the sale. . . .” However, this makes sense “if the security in question has its own independent value and was secured on the basis of that value. In project finance, the perspective is completely different [because] [s]ecurity is created in everything that has to do with the project.” In other words, the key assets of the project company “are not the physical assets but the contractual agreements which form the basis of the [project finance] arrangements.” “The project has value only if it is up and running and can generate revenues, which are used to repay the project loan and to compensate sponsors.”

29. Id.
30. GATTI, supra note 2, at 305.
31. Id.
32. Id. at 306.
33. Id.
34. Id.
35. GATTI, supra note 2, at 306.
36. Id.
37. Id.
38. Meaney, supra note 17, at 7.
39. GATTI, supra note 2, at 306.
that are subject to security" is not comparable to the amount of the loan; moreover,

this value shrinks even more if the project defaults, which is precisely when the issue of security enforcement comes into play. . . . These are the reasons why [the] step-in right[s] as a possible solution available to [the lender] in case the project faces a financial crisis. By means of such legal instrument . . . , [the lender] is entitled to take control of the project in order to remedy or make arrangements to remedy the default situation, as far as possible.  

Another argument for invoking the step-in right into the project finance arrangement is bankability. In order for an investment initiative to be made under project finance, the project should be bankable. This means that it should have project contracts containing certain legal provisions protecting the project company.  

Losing project contracts (which can happen . . . due to default by the project company) means jeopardizing the bankability of the project. This explains why lenders want to [have a right] to intervene directly [or indirectly] with respect to counterparties to project [contracts] if the project company is at risk of losing project contracts.  

In other words, it is in the lender’s interest to put a step-in right provision in the direct agreement to mitigate the risk of project contract termination because of force-majeure or default by the project company. The lender’s mitigation strategy may also include divesting the project company of the project contracts by assigning them to a third party - a possible buyer of the project who would step-in instead of the lender. In addition to these, the provisions granting the step-in right may also give the lender the right to be informed about the status of the project and any possible threats of termination of the project contracts.  

C. Variations of the Step-In Right

The lender usually wants to ensure that the project company will continue with the project after step-in. Moreover, the lender itself is not willing to be involved in the actual step-in. The lender generally mandates a “substitute” or “nominee” to step-in instead of the lender. Based on this, there are “three different levels of lender in-
tvention in the project: cure right, step-in right (in the strict sense) and novation/substitution." 47

1. Cure Right

The cure right allows "the lender[ ] to cure a breach of an obligation of the project company under one of the project documents." 48 For example, a need for using the cure right may arise when the project company constructing a pipeline is in arrears on its payments to its contractor for the pipeline construction services. In this case, to prevent the potential termination of the construction contract, the lender can cure the situation by paying the outstanding amount to the contractor instead of the project company.

"Lenders are generally hesitant to involve themselves in the cure of a project company breach unless the cure is limited to the payment of the amount due" by the project company to other persons (e.g., payment of insurance premiums to an insurance company, property taxes to the government). 49 If the lender does not exercise its right to cure the breach within the established cure period, the project company's counterparty "may proceed under its contractual remedies" (e.g., damages). 50 In Jeffrey Delmon's opinion, a cure right cannot be considered as a step-in right as it has a limited application, i.e., applied when "the default simply requires payment of [money], but otherwise the project company is performing well" and there is no substantial threat of project contract termination. 51

2. Step-In Right (In the Strict Sense)

The step-in right arises where a "project company breaches one of the project documents and the relevant project participant chooses to terminate." 52

The lenders are given a chance to step-in with the project company, cure the relevant breach and put the project back on track. The other project participants [e.g., contractors, suppliers, customers] will be required to continue fulfilling their contractual obligations with the new entity in lieu of the project company, although the project company will not be released from its obligations under the

47. See DELMON, supra note 40, at 81.
48. Id. at 82.
49. Id.; see Interview with John T. Wallace, supra note 9.
50. DELMON, supra note 40, at 82.
51. Id.
52. Id.
The project company would remain liable during the step-in and after the step-in period.\(^{53}\) Taking the same pipeline project example as described above, the possibility of exercising this kind of step-in right may come along when the project company is not simply behind on its payments, but also experiences other difficulties posing substantial risk of its default on the key project contracts, e.g., excessive expenses, serious technical shortcomings of the project, or low management potential. Once the lender steps-in and, after improving the situation, steps-out, the project company again becomes solely responsible for the project.

3. Novation

The final variation of step-in right implies transfer of all of the project company's rights and obligations to a substitute entity and removal of the project company from the project. This type of step-in right may require consent of "various project participants [e.g. contractors, sub-contractors, or customers]."\(^ {54}\)

The difference of novation from the step-in right, in a strict sense, is mostly a legal one: when the project company experiences severe difficulties, the lender instead of keeping the project company liable for the project can novate the whole project to another company which is more capable or fulfilling the project.

Another way of stepping in can be acquiring control over the project company through appropriating under contract the voting rights granted by its shares\(^ {55}\) and replacing the project company's board of directors.\(^ {56}\) This is not a step-in right in its conventional meaning, as it does not deal directly with preventing termination of contracts by counterparties; however, it can also be widely applied because of its potential effectiveness and simplicity.

Although it is very uncommon, instead of a step-in right some project financed structures might provide for the lender's obligation to step-in. For instance, an English case, The Royal Bank of Scotland PLC v. Chandra, is an interesting illustration of a bank agreeing to include into the agreement "a mandatory provision, requiring the

\(^{53}\) Id.

\(^{54}\) Id.


\(^{56}\) See VINTER ET AL., supra note 19, at 295; see also Cordeiro, supra note 8, at 167-68.
bank to step-in.”

The bank took the “unusual step of agreeing to this because the contractor [was] concerned about the ability of the defendants’ company to meet its obligations under the building contract and [refused] to enter into the building contract unless the bank provided some form of security.”

So, the step-in right served as a part of defendants' collateral warranty. When the project faced difficulties, the contractor “suspended work” and subsequently gave notice that it wanted the bank to step-in. The contractor “pointed out to the bank that the step-in provisions in the collateral warranty were mandatory and not optional.” The bank was “happy to step-in” via its nominee “on the basis that, since the development was not far from practical completion, it was important to retain the original contractor” and avoid further claims.

D. Events Triggering Step-In Right

From a legal point of view, each project document should have “its own termination regime, with [its own] events of default defined [on the basis of] the obligations of each party.” Meanwhile, the events such as liquidation or bankruptcy or extended force-majeure are common to all parties. To avoid the reference to the national laws, the parties to the project financed transaction can try to specify the default situations and grounds for termination in the respective loan agreement, direct agreement or other project contract. It is clear that all other project documents should closely follow the termination provisions stipulated in the key agreements mentioned above. The events that usually allow termination of the project contract, and therefore triggering the step-in right, are those related to non-per-
formance or insufficient performance by the project company. In ad-
tion to a default on the loan agreement as described above, the
following is a preliminary list of such events:

- failure to commence the work within a certain period [as pro-
  vided in the project agreement]
- failure to achieve completion within a certain period;
- abandonment of a portion of the project without consent;
- [project company's] bankruptcy;
- replacement of the operator [or contractor] other than in accor-
dance with the [project agreement];
- calling of loans above a certain threshold related to the project;
- failure to achieve a certain level of performance over time; or
- fundamental breach of any of the project documents.

In addition, others have found

- a prolonged force majeure event which will, or is likely to, cause a
  serious threat to the business;
- a material interruption or delay in the provision of the services;
- a serious risk to the health or safety of persons or property;
- step-in is required to comply with law; and/or
- step-in is required or advised by a regulator also trigger step-in rights.

E. Notification and Step-In Activities, Step-Out

A direct agreement needs “to specify how the [lender] may exercise
its step-in rights (e.g. whether the lender must notify the [project com-
pany and other project participants] in writing that it is exercising its
step-in right” (though the project agreement is supposed to have such
a requirement). The notice is expected to indicate what services the
step-in regime will cover. It is also likely that the direct agreement
and the notice should indicate a backstop date, i.e., the date when the
step-in period ends. Of course, the lender “will want its step-in
rights to be as flexible as possible” and retain it until the loan and the
interest accrued on it are paid in full. However, this is likely to be
resisted by the project company and project sponsors. Instead of
this, the lender should clearly identify all practical constraints relating
to its possible step-in and define for itself the concrete list of services

67. See supra Part II.C.1.
68. DELMON, supra note 40, at 402-03.
69. See McLean et al., supra note 6, at 3.
70. Id.
71. See id.; see also YESCOMBE, supra note 21, at 489.
72. McLean et al., supra note 6, at 3.
73. See id.
it is able to take over from the project company. If, for instance, the lender is dealing with services provided through a secured data center and has no detailed knowledge of the relevant processes and procedures, it would definitely not be feasible for the lender to "parachute" into such center and start telling someone else's employees how to run the services. In this case, the option with acquiring voting rights and replacing the board of directors would be more appropriate.

Although the lender is the one who is most keen to avoid bankruptcy procedures for the project company, if it fails and the project company becomes bankrupt, its position becomes much more complicated. In this case, the lender can rely only on the security over the project company assets as well as try to seek cooperation with the administrator in bankruptcy. In this scenario, the step-in right again proves useful: if a third party wishes to buy the project (let's say, an electric power plant or a pipeline) or any part of it within the bankruptcy procedure, the lender can assist in this by assigning to the new owner the relevant project contracts.

According to some authors, "[t]he period of step-in is [by default] at lender's discretion and [it] can 'step-out' again whenever [it] wish[es]." To ensure the lender's right to step-out, however, it is important to have it clearly provided in the direct agreement.

III. Lenders' Right and Liabilities with Respect to Third Parties: A Comparative Approach

Although the step-in right concept has not been extensively covered in the legal and business literature, it is usually described by various authors, including international institutions, as something common to lender's interests and incident to the project finance landscape. Meanwhile, many have not paid sufficient attention to the most basic area of step-in right regulation - its effect on the lender's rights and liabilities with respect to third parties. These are the issues governed

74. Id.
75. Id.
76. GATTI, supra note 2, at 307.
77. See id. at 306.
78. Id.
79. See YESCOMBE, supra note 21, at 195.
by contract law. To cover these issues, this Article will concentrate on the analysis of third-party contract law implications related to exercising the step-in right in some common law and civil law jurisdictions, namely the U.S., the U.K. and France.

A. U.S.: Assignment and Delegation

The underlying concepts governing the regulation and interpretation of the step-in right in the U.S. are "assignment of rights and delegation of performance of duties."81

As described in the influential Allan E. Farnsworth's treatise, *Farnsworth on Contracts*,

an obligee's transfer of a contract right is known as an assignment of right. By an assignment, the obligee as assignor (B) transfers to an assignee (C) a right that the assignor has against an obligor (A). An obligor's empowering of another to perform the obligor's duty is known as delegation of the performance of this duty. By a delegation, the obligor as delegating party (B) empowers a delegate (C) to perform the duty that the delegating party owes to an oblige (A). A party to a contract that both assigns rights and delegates performance to another person will be referred to as transferor (B); the other person will be referred to as transferee (C); and the transaction will be called as transfer of contract.82

When exercising its step-in right, the lender is a transferee, as it accepts from the project company a number of contracts with contractors, suppliers, customers, etc. As the application of assignment and delegation regulations entails, the contracts to be transferred should be carefully assessed by breaking them down into groups of rights and obligations.

First of all, it should be noted that not all rights are transferrable. For instance, the lender cannot be assigned by the project company its bank deposits or right to payment under public contracts (except for some exemptions).83 Moreover, the assignment of some of the project company's contracts may be considered by a court to be ineffective if the court finds the assignment violates public policy.84

The lender might be barred from exercising a step-in right when the relevant contract contains a provision prohibiting assignment. However, absent a contrary indication, a prohibition of an assignment of

81. 3 EDWARD A. FARNSWORTH, FARNSWORTH ON CONTRACTS 58 (1990).
82. Id.
84. See, e.g., Kenrich Corp. v. Miller, 377 F.2d 312, 314 (3d Cir. 1967) (finding that an assignment is ineffective as "offend[ing] public policy... if it provides for the institution of litigation by and at the expense of a person who, but for that agreement, has no interest in it.")
"the contract" is to be interpreted as barring only the delegation of duties not the assignment of rights.\textsuperscript{85}

Another critical risk the lender should avoid is revocability of the assignment. The general rule in the U.S. is that "gratuitous assignment[s] [are] revocable."\textsuperscript{86} In this regard, the lender should pay a certain value for receiving the rights under the contact or provide for specific language in the direct agreement confirming that the assignment is not made for free, that it is made for meaningful "consideration." According to Farnsworth, even if the project company has the power to terminate a gratuitous assignment when it is made, the project company may lose that power as the result of lender's subsequent acts (e.g., obtaining the performance from the contractor).\textsuperscript{87}

If the parties provided for "assignment of contract" as a part of the step-in right mechanism, this language will ordinarily delegate performance as well as assignment the rights.\textsuperscript{88} "No delegation of performance relieves the project company of any duty to perform or any liability for breach."\textsuperscript{89} At the same time, the lender should understand that if it gives a promise to the project company to perform the duty (including via demonstration of the relevant conduct) this will be deemed as assumption of the duty by the lender and the lender undertakes a duty to the project company\textsuperscript{90} and usually to the project company's counterparty as the intended beneficiary.\textsuperscript{91} It should also be noted that if the lender assumes the duty and the project company's counterparty releases the project company in exchange of the new liability of the lender, this would create a novation making the lender solely liable for the obligations of the project company.\textsuperscript{92}

It is perfectly understood that the lender will want to avoid assuming any liabilities under any contract the project company has entered into with the contractors or to limit its liability to the maximum ex-

\textsuperscript{85} See U.C.C. § 2-210(3); but see Union Bond & Trust Co. v. M & M Wood Working Co., 474 P.2d 339, 352 (Or. 1970) (finding that "rights or duties created by contract may not be assigned if they involve the peculiar fitness or ability of the person performing the contract or when the contract is made by reason of the trust and confidence placed by one party in the other party to the contract.").

\textsuperscript{86} See Restatement (Second) of Contracts § 332(2) (1981).

\textsuperscript{87} See Farnsworth, supra note 93, at 138.

\textsuperscript{88} See U.C.C. § 2-210(4); Restatement (Second) of Contracts § 328(1).

\textsuperscript{89} See U.C.C. § 2-210(1).

\textsuperscript{90} If the delegate fails to perform and the delegating party performs, or is required to pay damages, the delegating party may recover from the delegate. See e.g., Imperial Ref. Co. v. Kanotex Ref. Co., 29 F.2d 193, 199-200 (8th Cir. 1928); Cutting Packing Co. v. Packers' Exch. of Cal., 25 P. 52, 53 (Cal. 1890).

\textsuperscript{91} See, e.g., Imperial Ref. Co., 29 F.2d at 200.

\textsuperscript{92} See Farnsworth, supra note 93, at 141-42.
tent. Therefore, to facilitate the interests of the lender, the direct agreement, including the step-in right provisions, should be properly drafted. The Model Consent to Assignment for Project Finance Transactions prepared by the Project Finance and Development Committee of the ABA Section of Business Law would serve as a perfect guideline for negotiating and drafting the direct agreement. In addition to increasing the efficiency of drafting and negotiating the project documents, the Model Consent to Assignment allows the lender to mitigate the risks of assuming additional liabilities. At the same time, the Model Consent to Assignment cannot provide full protection. Namely, Footnote 29 in the Model Consent to Assignment says that “the contracting party (e.g., contractor acting as the project company’s obligee) in most cases would also have recourse to the [lender]” who has stepped in for all its liabilities that arise during the step-in period.

**B. U.K.: Receiver and Substitute Obligor**

As cautioned by Graham Vinter, “the phrase step-in is a notoriously vague one and the way that lenders will typically step into an English company is to appoint an administrative receiver over it.” Receiver is the “one placed in the custodial responsibility for the property of others, including tangible and intangible assets and rights,” especially in cases where a company cannot meet its financial obligations or enters bankruptcy. According to Philip Wood, “the use by banks of receivership in English-based jurisdictions - a kind of possessory management of the debtor via an accountant - is extremely common and has been around for 160 years or so.” However, according to Graham Vinter, “prudence dictates that it will be better for lenders to be rather more expansive about the arrangement they have in place for carrying out the project (as would normally be the case in the typical direct agreement).” Indeed, in 2005 an English court held that the mere fact that a lender could appoint a receiver was not

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94. See id. at 1203.
95. See id. at 1209 n.29.
96. VINTER ET AL., supra note 19, at 263.
98. Interview with Philip Wood, supra note 9.
99. VINTER ET AL., supra note 19, at 263.
sufficient to enable the lender to have step-in rights for the purposes of the project finance transaction.\textsuperscript{100}

The step-in right (either through receivership or more expansive practice) is normally stipulated in a direct agreement, and this approach is widely adopted in the London market.\textsuperscript{101} Moreover, in light of the Contracts (Rights of Third Parties) Act 1999, the simple inclusion of the step-in right provision in the underlying project contract will also "technically . . . give the lender the benefit[s]" of a step-in right provided that it follows the necessary procedures as set out in the Act.\textsuperscript{102} Namely, "the [project] contract should state that the lender[ . . . [is] able to enforce the relevant [step-in] provisions, the lender[ . . . should notify the [parties to the contract] that [it] relies on [these] provisions," and the contract should also provide that these "provisions cannot be rescinded or varied without the lender's consent."\textsuperscript{103}

The receiver is also referred to as "additional obligor" who will be often jointly and severally liable with the project company during the step-in period (in effect, it constitutes an "assumption" as described above).\textsuperscript{104} As an alternative for an "additional obligor" when exercising its step-in right, banks may novate the project contract to another person as part of a trade sale.\textsuperscript{105} The buyer or other designee substitutes for the project company and thus is sometimes referred to as a "substitute obligor." The substitute obligor, post-novation, will have sole responsibility under the contract (in effect, it is a "novation" as described above).\textsuperscript{106}

Of course, lenders will seek to limit their liability on step-in. They can insist, for example, that their receiver will only be responsible for those liabilities of which the project company has been expressly notified by the lenders. They can also seek to negotiate a cap on the amount of such liabilities.\textsuperscript{107} However, it seems that this is hard to achieve, as the third party will argue that the outstanding liabilities should be paid as a precondition to any step-in action.\textsuperscript{108}

\textsuperscript{100} See \textit{Feetum v. Levy}, [2005] EWHC (Ch) 349, [59] [2005] 1 W.L.R. 2576 (Eng). It should be also noted that projects in some sectors (most notably oil and gas projects in the North Sea) have not, to date, included step-in rights in the strict sense although the lenders were entitled to appoint receivers.

\textsuperscript{101} See \textit{Vinter et al.}, supra note 19, at 280.

\textsuperscript{102} \textit{Id.} at 279.

\textsuperscript{103} \textit{Id.}

\textsuperscript{104} See \textit{Vinter et al.}, supra note 19, at 275.

\textsuperscript{105} \textit{Id.} at 275.

\textsuperscript{106} See id. at 277.

\textsuperscript{107} \textit{Id.} at 103.

\textsuperscript{108} See id. at 194.
The new counterparties of the lender will probably object as to the identity of any proposed substitute obligor taking into account that, following the novation, the project company will be released from liability under the contract. The lender, however, will probably seek to limit the grounds on which the third party can object to a proposed substitute.

C. France: Lender as Beneficiary

In France, there are legislative provisions dealing with step-in rights of public authorities; however, there are no such “in favour of banks or other third parties.” Indeed, for example, in the 2006 Eurotunnel case, the validity of step-in rights granted to the banks under the concession was questioned in view of French insolvency rules “despite the fact that the [Eurotunnel] concession and the step-in rights provided therein were approved by an international treaty and the [domestic] law of France.”

Although not properly supported by statutory law, the step-in rights granted to the lenders in France remain to be pure contractual undertakings. “In the absence of a step-in right provision in the direct agreement, step-in rights may be structured through [the provision in the project contract of a] stipulation pour autrui, [the] mechanism provided in the French civil code and . . . existing in many civil law countries.” By stipulation pour autrui, the obligor (contractor) “undertakes vis-à-vis a stipulating party [(project company)] to do or not to do something in favor of a third party beneficiary (lender).” The “interesting feature” of this mechanism is that the lender “does not need to be a party to the agreement between the [project company] and the [contractor].” The lender “only has to accept by a [single] notification to the [contractor] that the stipulation pour autrui has been made in its favor.” So, under stipulation pour autrui, the contractor “undertakes vis-à-vis the project company . . . to transfer the [project] con-

109. See Maggiar, supra note 10, at 3.
111. See Maggiar, supra note 10, at 9.
112. INTERNATIONAL PROJECT FINANCE, supra note 110, at 380.
113. Id.
114. Id.
115. Id.
tract to [the lender] or any party designated by the lender.”\textsuperscript{116} Acceptance of the lender of *stipulation pour autrui* entitles the lender to enforce the step-in right[ ].”\textsuperscript{117}

After notifying the project company or the contractor, generally the lender (or its substitute) “becomes jointly and severally liable with the [project company] for [its] obligations under the project [contract].”\textsuperscript{118} However, French legislation also provides for the possibility of “substitution” or “novation,” similarly as in the common law jurisdictions.\textsuperscript{119} According to one French practitioner, “if there is a transfer of the [project company’s] rights and obligations under the project [contract],” the common rule is that the defaulted project company is “released from all its obligations, and its rights are cancelled.”\textsuperscript{120}

When deciding which law among those described above should be chosen to govern the step-in right, it would be important to understand that the step-in right mechanism is driven not only by contractual arrangements but also various regulations and, which is most important, existing legal practice. Taking into account that the step-in right concept has emerged within common law jurisdictions, French law would not be the best option as governing law. To ensure the most efficient formulation, interpretation and implementation of the step-in right, English or American law would be more preferable.

IV. CHALLENGES AND CONSTRAINTS

Prior to including into an agreement a provision about the step-in right, the lender should identify the potential challenges and constraints related to its exercise. Such constraints could be a problem as they can nullify the effect of exercising a step-in right and raise the question of its enforceability.\textsuperscript{121} Following is a discussion of the other key challenges and constraints associated with the step-in right that can relate to various legal, economic and administrative aspects of this complex legal structure.

\textsuperscript{116} Id.

\textsuperscript{117} International Project Finance, supra note 110, at 372.

\textsuperscript{118} Maggiar, supra note 10, at 5.

\textsuperscript{119} See id. at 3.

\textsuperscript{120} Maggiar, supra note 10, at 5.

\textsuperscript{121} Some constraints have been discussed above in the part relating to the contract law regulation of the step-in right. See supra Part II.C.
A. Technical Features of the Project

If the services are provided by the project company from a remote location or if the project includes a number of industrial facilities located in various jurisdictions, as the case may be for cross-border pipelines or electricity transmission projects, this may make any immediate step-in extremely difficult from technical perspective.

B. Level of Lenders' Internal Capacity and Expertise

Banks are “not set up to run a step-in service effectively.” They simply do not have the necessary skills and experience that would enable them to do this. Lenders are not willing to run the project themselves, and, moreover, they are often unable to find another party that is willing and able to step in to the project within a tight timeframe. According to Henry Lee, he has “seen several cases where the government pays the second highest bidder a fee to be prepared to step in to a concession, if the original high bidder does not meet its obligations.” Similarly, if the project contract is awarded through public bids, a possible solution for the lender could be its agreement with the second bidder. For this purpose, the lender in addition to negotiating with the winner of the bids the conditions of financing the project, may also try to negotiate with the second bidder the conditions of its step-in to the project as the lender’s nominee if the winner of the bids fails. Thus, the lender will be guaranteed that in the event of default the lender will be able to substitute the winner by the second bidder and, therefore, have the loan being repaid uninterruptedly.

C. Human Resources Management and Counterparty Risks

The lender can always face opportunistic behavior of the project company’s management, employees, contractors and suppliers who may not be willing to cooperate with the lender or its substitute if they decide to step-in. It will also be common for them to use such an approach with the aim of negotiating better conditions of their respective contracts. This problem is hard to avoid; however, it is avoidable if the lender has the power to change the project company management as part of its step-in rights and is able to do that promptly. Prior to stepping-in, the lender should also understand the potential risks

122. Interview with Henry Lee, Jassim M. Jaidah Family Dir. of the Env’t and Natural Res. Program, Belfer Ctr. for Science and Int’l Affairs, Harvard’s John F. Kennedy School of Gov’t (Feb. 20, 2014) (on file with author).
123. Interview with John T. Wallace, supra note 9.
124. Interview with Henry Lee, supra note 122.
125. See VINTER ET AL., supra note 19, at 22.
that may be related to its new counterparties. If, for example, the project company's contractors are experiencing financial distress, it would not be an advantage for the lender to step-in and deal with insolvent contractors unless the lender is able to promptly replace them.

D. Lack of Licenses and Permits Required to Perform the Services

This can be a serious legal impediment to the lender or its nominee when it concerns "regulated assets" or services, as government authorizations cannot be regulated contractually unless the respective public authority is a party to the project contract. It is obvious that to mitigate this risk, the licensing authority should assume an obligation under contract to transfer the license or permit to the lender or its nominee in case either steps-in. If the authority refuses to do so, the step-in plan will be at high risk. Some countries try to address this situation through adopting relevant statutory provisions. For example, according to the Turkish Electricity License Regulation, in the event of the project company's default, the lender who has given loans to the said project company on a project finance basis, is "entitled to request from the Energy Market Regulatory Authority transfer of the existing license of the project company to itself or a new entity, which will undertake all the obligations of the project company." From this language it appears that it is just a partial measure, as the Energy Market Regulatory Authority is not obliged to grant the request of the lender.

In addition, as noted by John T. Wallace, direct owning and operating regulated asset may have far reaching consequences, as this "may subject the lender or its parent to unwanted regulation." For example, "in the U.S. a lender owning certain types of energy assets may become a regulated utility requiring extra compliance costs and limits on future investments."

126. Interview with John T. Wallace, supra note 9.
127. For example, PFI.
129. Interview with John T. Wallace, supra note 9.
130. Id.
E. Triggering a Step-In Right

Exercising the step-in right primarily depends on the occurrence of events provided in the direct agreement.\textsuperscript{131} It is evident that the project company is likely to insist on providing within the direct agreement a “very limited and narrowly defined list of triggers ... linked to material failures or critical circumstances” (e.g. material delay of provision of services, termination of key supply contracts, etc.).\textsuperscript{132} The lender may push for a broad list of triggers, treating the step-in right as a “magic bullet” for all service delivery disruptions. In this case, both the lender and the project company should be realistic when defining the events triggering a step-in right.\textsuperscript{133} The parties should define as triggers only those circumstances to which there is not an immediate remedy. If, for instance, in the case of disruption of delivery of services, a project company has an opportunity to relocate the delivery from a primary to a back-up site, that should not be covered by the triggers.\textsuperscript{134} The lender and the project company can also stipulate for an independent person who will be responsible for defining whether the event triggering a step-in right has occurred, because determining this moment can also be disputable between the parties.\textsuperscript{135}

F. Competing Step-In Rights

The projects involving a public authority, such as concessions, may provide for the public authority’s right to step-in and run the project when it is in trouble. Such a right, for instance, is also called by some authors a “right to intervene.”\textsuperscript{136} In the case of such a project, the direct agreement should set the relationships between the right to intervene and the lender’s step-in right. Absent the contractual provisions, the approach to be undertaken to this problem should be based on the legal doctrine of “first in time is first in right.”\textsuperscript{137} However, this doctrine should be further extended in a way that if the public authority steps in first, the lender should not object as long as the public authority takes the responsibility for repayment of the loan. If the lender steps in first, the public authority should not object as the lender becomes subject to the public authority right to intervene.

\textsuperscript{131} See, e.g., supra Part II.D.
\textsuperscript{132} McLean et al., supra note 6, at 3.
\textsuperscript{133} See id.
\textsuperscript{134} See id.
\textsuperscript{135} See VINTER ET AL., supra note 10, at 98.
\textsuperscript{136} See, e.g., DELMON, supra note 40, at 135.
\textsuperscript{137} In the US, this approach is well defined in the property law case Palmer v. R.R. Comm’n of California, 138 P. 997 (Cal. 1914).
should the lender fail to improve the situation within reasonable time.\textsuperscript{138}

\textbf{G. Competition and Public Procurement Laws}

Another serious issue that may arise when it comes to a project involving a public authority is competition. "The right of the lender to replace the existing project company with another operating company is based on the lender's sole discretion. It does not permit an open offer where the credentials of more than one prospective operator are considered."\textsuperscript{139} Therefore, step-in by a lender or its nominee through substitution could be objectively viewed as violation of public procurement rules. For instance, in Russia, a lender's step-in rights are restricted: the law does not allow lenders to appoint their nominee in the course of their step-in; rather, the law requires that a nominee is selected on a tender held by the public authority.\textsuperscript{140} So, if the lender finances a project in a jurisdiction limiting the lender's step-in right, the lender or its nominee has to be prepared to go through the burdensome public tender procedures at the expense of the potential efficiency of immediate step-in.\textsuperscript{141} Less strict regulations exist in Estonia, for example, where a public authority may consent to a step-in by lender's nominee provided that the nominee meets the criteria applicable to a "tenderer under procurement proceedings" and the "economic and financial standing and technical and professional competence of the nominee complies with the qualifications provided in the contract notice."\textsuperscript{142}

\textbf{H. Adverse Effect on Continuity and Quality of Services}

Lastly, even if the lender's nominee is allowed to replace the project company, if its step-in has not been smooth, it can negatively affect the continuity of services and their quality. This may lead to the termination of the contracts with the project contractors, customers, and suppliers and cause ultimate failure of the project.

Although what has been mentioned above is not an exhaustive list of possible challenges and constraints applicable to the step-in right, it

\textsuperscript{138} See Delmon, \textit{supra} note 40, at 135.
\textsuperscript{141} As an option, step-in could be effectuated through transfer of shares in the project company, subject to this being allowed under the contract with the public authority and applicable law.
\textsuperscript{142} See Eespold & Hammerberg, \textit{supra} note 55.
is sufficient to reach a conclusion that exercising a step-in right is a very risky and adventurous undertaking. Having come to such conclusion, should we treat step-in right as something totally impractical and useless? This it is not an easy question, and it will be reviewed in more detail in the conclusion below.

V. Conclusion

This Article explained the concept of the step-in right. It determined that a step-in right should be considered as a transfer of contractual rights and obligations the project company has with regard to its counterparties, to the lender when the project comes into difficulty. The Article covered contract law regulations of step-in right in the U.S., the U.K. and France. Although the respective regulations have some specific features, they confirm that the step-in right (apart from its “light” cure right variation) can be exercised in a dual way: 1) by stepping in and holding the project company liable for its obligations along with the lender or its nominee, or 2) by stepping in and replacing the project company so that the lender or its nominee becomes solely liable to the project company’s counterparties. The reasons for exercising step-in rights, triggering events as well as various challenges and constraints related to step-in right, have been discussed.

The research conducted permits coming back to the main question of this Article: whether the step-in right is a plausible remedy for a lender in project financed transactions? It is not surprising that this Article responds to this question with the best answer to almost any legal question: “It depends.” As noted above, the benefit of the step-in right lies within its protective nature.\footnote{143. See supra Part II.A.} The financing given to the project constitutes the value of the project, while the main asset of the project company is its contractual relationships with its counterparties. In this respect, exercising security measures against the project company’s tangible assets appears to be the remedy of last resort. Moreover, when the project company is in trouble, exercising security measures may cause a “fire sale” which can significantly reduce the value of such assets.\footnote{144. See Andrei Shleifer & Robert W. Vishny, Banking and Securitization: Asset Fire Sales and Credit Easing, 100 AM. ECON. REV. 46 (2010), available at http://scholar.harvard.edu/files/shleifer/files/asset_fire_sales_aer_published.pdf.} In light of the low effectiveness of conventional security measures, the step-in right appears to be not simply a remedy that is “nice to have” in the contract but rather a relatively powerful tool. Indeed, a step-in right allows the lender to interfere with the project and try to revitalize it before it goes to bankruptcy.
Moreover, the lender can delegate exercising the step-in right to another party, probably one that is fitter to implement these procedures. In the author's opinion, these features of the step-in right make it a quite plausible remedy.

But there is still a large room for doubt in assessing the plausibility of an instrument such as a step-in right. As noted above, there is no evidence of wide practice of exercising step-in rights. Exercising a step-in right is not an easy process, and the way to an effective step-in right runs through a host of pitfalls, some of which could be fatal from the outset. Practicing lawyers writing about step-in rights also agree that "enforcement of step-in rights would probably be difficult, if not impossible in practice."145 So what can be done to make the step-in right a remedy with teeth, an effective tool to deal with critical project failures? The answer is quite simple: be more realistic about what is achievable and what is not, be aware of the mechanics of step-in rights, rigorously draft and navigate through the contract provisions to avoid relevant pitfalls. To be more specific, the following measures might be proposed to a potential lender to increase the efficiency of step-in right:

- Carefully assess the step-in provision against the assignment rules of the jurisdiction covered by the project. The lender should be cautious as to what can be assigned under contract and what assignment technics are stipulated or practiced within this jurisdiction. To assure more flexibility in regulation and interpretation of the step-in right, the lender should prefer common law (such as English law or law of some of the U.S. jurisdictions) as the law governing and interpreting the step-in right. Moreover, it would be advisable to follow the Model Consent to Assignment if it concerns American law.
- Avoid assuming an obligation to step-in, as this obligation may be used by the project company to avoid its liability following the lender's step-in.146
- Thoroughly review the technical complexity of the project and assess one's own expertise and capacity to step-in, and take preventive measures by finding a substitute for the current project company in advance.
- Establish a permanent and reliable oversight mechanism to overcome the asymmetry of information incident to projects of such kind.147 This would allow the lender to be aware of the economic, management and legal background of the project before stepping-in and thus minimize the risks associated with the pro-

145. See Maggiar, supra note 10.
147. Interview with Henry Lee, supra note 122.
ject company’s internal mismanagement or undesirable performance of its personnel and counterparties.

- Identify all licenses and permits necessary to successfully run the project and get, if possible, government guarantees on their issuance if the lender (its nominee) decides to step-in.

- Clearly formulate the project company’s default events, remaining realistic about what remedies the lender might invoke if any of such events occur.

- If the project involves a public authority, delineate the lender’s right to step-in and the public authority’s right to intervene by agreeing on the conditions of exercising each of the rights and, where necessary, provide for subordination of rights.

- Determine whether the potential exercise of a step-in right might be affected by public procurement laws, and, if yes, be prepared for the tender by properly negotiating its terms in the direct agreement and allocating the relevant time and costs.

- Stay tuned to the needs of the customers when stepping-in, as failure to provide uninterrupted and quality services may result in losing the customers of the project and ultimate failure of the project.

Even if upon preliminary analysis it is not clear whether the step-in right would be effective, it should be noted that it might still be beneficial for the lender. For instance, the lender can use it as a strong leverage in negotiations. The Eurotunnel case is an example, where in 2004, when the “concession company was on the verge of bankruptcy, [the lenders] envisaged exercising their step-in rights as stipulated in the concession agreement.”

The validity of step-in rights was questioned in view of French insolvency laws. However, regardless of their validity, step-in rights in this case were used by the lenders as a means of pressure to obtain a settlement, and the existence of this threat probably contributed to the successful outcome of negotiations leading to the 2007 rescheduling and safeguard plan.

Of course, there could be situations when step-in is impossible. In such a case, even though the sponsors and the project company will resist, the lender should probably insist on a higher interest rate and/or sponsors’ escrow accounts guaranteeing the project company’s performance. Thus, if the lender does achieve an effective step-in right, that can be viewed as a means reducing transactional costs.

This research confirms that step-in right remains a complex and interesting legal phenomenon that, depending on the features of the particular project and the level of legal techniques, can be a great ben-

148. However, as noted by John T. Wallace, a lender can better use as leverage its right to foreclose against the project’s assets. Interview with John T. Wallace, supra note 9.
149. INTERNATIONAL PROJECT FINANCE, supra note 110, at 380.
150. Id.
efit for the lender or an absolutely useless contractual structure. It should also be evident that the concept of the step-in right, comprising various legal issues, deserves further detailed analysis by academia and wide practical approbation by project finance participants.